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<p>Tiivistelmä-Referat-Abstract</p> <p>This thesis explores the factors, which determine the real exchange rate in developing country based on the Montiel's equilibrium real exchange rate analytical framework considering internal and external balance framework. To carry out the analysis, an empirical model of estimating the equilibrium real exchange rate and measuring the exchange rate misalignment in China is developed.</p> <p>The departure point of the theory framework is to define the real exchange rate following the Swan-Salter ratio according to the TNT model; then based on the Montiel's theory, considering the equilibrium RER as a path upon maintains both internal and external balance in an economy. The analytical framework is designed to identify the determinants of the long-run equilibrium real exchange rate. By analysing the production, household behaviour, and public sector of an economy to get both the internal and the external balance, we choose the four fundamentals as the determinants of the real exchange rate in China, they are, the domestic supply-side factors, fiscal policy, international economic environment and commercial policy.</p> <p>In estimation, first we test for the stationary of real exchange rate and its underlying determinants using unit root DF and ADF tests. It shows that all the variables can be described as a stationary process having one unit root; second, using the Engle-Granger two-step OLS method to estimate the cointegration and error correction relation between the RER and its fundamentals. Finally the misalignment would be calculated by the estimation. The cointegration model shows that the empirical result coincides with the analysis of Montiel's theory.</p> <p>The objective of this thesis is to set out for assessing exchange rate misalignment in developing countries where data, time and professional capacity are limited. The research draws together methodologies from disparate sources, how to define and measure the actual RER, how to choose the fundamentals of RER, and how to estimate the equilibrium RER. Among them the fundamentals choosing is the central problem, which depend on the particular economy itself.</p>			
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